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U.S. Supreme Court extends whistleblower protection to employees of a public company's private contractors

March 6, 2014 | W. Kelly Johnson

In a 6-3 decision, the U.S. Supreme Court decided earlier this week that whistleblower protection under the Sarbanes-Oxley Act of 2002 includes employees of a public company's private contractors and subcontractors. In *Lawson v. FMR LLC*, the court, in a majority opinion written by Justice Ginsburg, concluded that extending protection to employees of a contractor was consistent with the purpose and intent of Sarbanes-Oxley: to protect investors and restore trust in financial markets.

As background, plaintiffs Lawson and Zang separately initiated lawsuits against their former employer, a privately held company that provided advisory management services to the Fidelity family of mutual funds. The mutual funds were not parties to the action because, as is common in the mutual fund industry, the Fidelity funds had no employees. Instead, the funds contracted with investment advisors like FMR to handle the day-to-day operations of the funds. After they were terminated, Lawson and Zang alleged that they were fired in retaliation for raising concerns about cost accounting methodologies and inaccuracies in SEC registration statements for the funds. FMR sought to have the actions dismissed, but those motions were rejected by the trial court.

In a 2-1 decision, the U.S. First Circuit Court of Appeals reversed the trial court and found that the whistleblower protections of Sarbanes-Oxley were available only to employees of the public companies, and did not cover a contractor's employees.

In deciding that whistleblower protection extended to contractors of public companies, the Supreme Court focused on a narrow provision of Section 1514A which provides that "no company … or any … contractor … of such company may [retaliate] against an employee … because of [whistleblowing]." In reaching its decision, the court focused on a plain reading of the statute and concluded that "A contractor may not retaliate against its own employees for engaging in protected whistleblowing activity."

The majority found this interpretation consistent with the history and purpose of Sarbanes-Oxley, which was enacted in response to the collapse of Enron. The congressional record confirmed the focus of Congress on the activities of contractors, including accountants and attorneys, who had failed to disclose accounting reporting irregularities concerning Enron to regulators, out of fear of retaliation by their employers.

In its decision, the court rejected two arguments forwarded by FMR. FMR argued that an "employee" must be limited to public company employees to avoid the "absurd" result of extending protection to the personal employees of company officers and employees. The court rejected this argument and found that nothing in the record suggested that Congress intended this interpretation or that " few housekeepers and gardeners" would be likely to be exposed to evidence of their employers complicity in fraud.

In addition, FMR argued that the statutory headings of Sarbanes-Oxley, including the heading "Whistleblower Protection for Employees of Publicly Traded Companies," provided evidence that Congress intended to limit the focus of the act to employees of public companies. The high court relied on the decision of Trainmen v. Baltimore & Ohio R. Co. to find that the headings and titles of the act were not meant to take the place of the detailed provisions of the act.

An analysis of the decision indicates that the history and background of Sarbanes-Oxley underlies the basis for the court's interpretation. Specifically, the court found that Congress included whistleblower protection in Sarbanes-Oxley as a means to ward off another Enron "debacle." The Senate report recognized that outside professionals, including accountants, lawyers and contractors were complicit in, if not integral to, the shareholder fraud and subsequent cover-up. In fact, Congress cited examples that focused on outside professionals and discussed possible retaliation by their employers to support Sarbanes-Oxley. Further, the majority could not accept that it was Congress' intent to leave professionals vulnerable to discharge in retaliatory action for complying with federal securities law.

The court also rejected the practical effect of FMR's arguments which would have virtually insulated the mutual fund industry from Sarbanes-Oxley whistleblower protection. Because virtually all mutual funds have no employees, and are managed by independent investment advisors and consultants, whistleblower protection is necessary to protect insiders who are the only firsthand witnesses of shareholder fraud.

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SEC issues no-action letter regarding transfer of ownership of privately held companies

February 21, 2014 | Mark Koogler

Earlier this month, the Securities and Exchange Commission (SEC) issued a no-action letter indicating the staff of the Division of Trading and Markets would not recommend enforcement action if an "M&A broker" were to engage in the transfer of the ownership and control of a privately held company through the purchase, sale or transfer involving securities or assets of the company, to a buyer who will actively operate the company or the business conducted with the assets of the company, without registering as a broker-dealer.

An M&A broker may not:

1. have the ability to bind a party to an M&A transaction described above;
2. provide financing for the M&A transaction;
3. have custody, control or possession or otherwise handle funds or securities issued or exchanged in the M&A transaction; or
4. facilitate an M&A transaction with a group of buyers if the group was formed with the assistance of the M&A broker.

The buyer in the M&A transaction may not be a passive investor. The buyer must acquire control and actively operate the company or the business conducted with the assets of the company. Control may be acquired through the ownership of securities, by contact or otherwise. Control is presumed to exist if the buyer or group of buyers has the right to vote 25% or more of a class of voting securities or in the case of a partnership or limited liability company, has the right to receive upon dissolution or has contributed 25% or more of the capital.

For purposes of the no-action letter, a privately held company is a company that does not have any class of securities registered or required to be registered with the SEC under the Exchange Act or is required to file periodic information, documents or reports under the Exchange Act. There is no size limitation with respect to a privately held company under the no-action letter.

The no-action letter is limited to broker-dealer registration under the federal securities laws and does not preempt or otherwise override state laws. In addition, HR 2274 is under consideration by the U.S. Senate, after being unanimously passed by the U.S. House of Representatives, which would exempt M&A brokers from registration as a broker-dealer. Certain provisions of HR 2274 are contrary or inconsistent with the SEC no-action letter, and the SEC would be required to revise the conditions and prohibitions set forth in the no-action letter if HR 2274 were to be enacted into law.

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ISS 2014 U.S. proxy voting guidelines

December 20, 2013 | Jack Gravelle

Yesterday, proxy advisory firm ISS released its 2014 proxy voting guidelines, effective for shareholder meetings held on or after Feb. 1, 2014. ISS positions on some topics continue to evolve. Below are some notable differences from the 2013 Guidelines:

When determining votes on director nominees, four fundamental principles continue to apply: (1) accountability; (2) responsiveness; (3) independence; and (4) composition (last year "composition" was referred to as "competence"). The description of "independence" is more robust than last year, including a statement that "the chair of the board should ideally be an independent director," which is not surprising given that ISS has previously supported shareholder proposals requiring an independent chair.

In 2013, ISS recommended withholding votes for directors if the board failed to act on a shareholder proposal that received the support of a majority of the shares outstanding the previous year. For 2014, ISS will recommend voting case-by-case in that scenario and will consider various factors including the subject matter of the proposal and the rationale provided in the proxy statement for the level of implementation.

Finally, ISS has expanded on the factors it will consider in determining how to vote on proposals to recoup incentive cash or stock compensation made to senior executives when the calculations turn out to be based on erroneous figures. Such factors include consideration of the rigor of the policy and how and under what circumstances compensation is subject to the clawback.

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SEC proposes rules for crowdfunding securities offerings

October 24, 2013 | Andrew Trafford

The SEC voted unanimously to propose rules regulating the offering and selling of securities through "crowdfunding". Crowdfunding – a method of raising money through small sums contributed by many individuals – has become an internet mainstay. But so far, crowdfunding websites (such as Kickstarter or Indiegogo) constructed their platforms so as to avoid falling under SEC regulation. In particular, the traditional crowdfunding method does not offer financial returns on an investment or a share in a company's profits.

The proposed rules (read them in their entirety) would allow companies to raise up to $1 million through crowdfunding platforms within a 12-month period. Other features of the proposed rules include:

- Investors will be subject to income-based limits on the total amount of securities they can purchase through crowdfunding within a 12-month period. No investor will be able to invest more than $100,000 in crowdfunding-based securities within a 12-month period.
- Certain companies will be ineligible to raise funds through crowdfunding, including: companies that are already SEC-reporting companies, non-U.S. companies, companies with no specific business plan, and certain investment companies.
- Companies will be required to file certain information with the SEC.
- Companies are required to disclose certain information to the crowdfunding platform and prospective investors, such as financial statements, related-party transactions, the company's business plan, and description of the offering.
- Crowdfunding platforms will have to become registered with the SEC, either as broker-dealers or funding portals.

The rules were proposed as directed by the Jumpstart Our Business Startups Act (JOBS Act), which was passed in part to assist small-business fundraising and directs the SEC to draft an exemption for crowdfunding platforms from the securities laws. The rules will be subject to comment for 90 days. The SEC includes prompts in the proposed rules for comments, which can be submitted electronically.

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District Court dismisses conflict minerals challenge

July 25, 2013 | Daniel Bauer

On July 23, 2013, the United States District Court for the District of Columbia dismissed the challenge to the Securities and Exchange Commission (SEC) conflict minerals rules (the Rules) brought by a group of trade associations. The Rules were issued under Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and require that public companies disclose the country of origin of certain minerals used in the products they manufacture or contract to manufacture.

Court Decision

The court determined, among other things, that:

1. Although the SEC is required to consider the economic implications of a proposed rule, there is no statutory support for the plaintiffs' argument that the SEC was required to consider whether the Rules would actually achieve the social benefits that Congress envisioned in enacting Section 1502 of the Dodd-Frank Act.
2. Because the SEC issued the Rules pursuant to an express statutory directive from Congress via Section 1502 of the Dodd-Frank Act, the SEC rightly deferred to Congress's determination that the due diligence and disclosure requirements of Section 1502 would help promote the social benefits envisioned by Congress. The SEC's correct role was to issue a rule that would promote the benefits that Congress identified and hew closely to that Congressional command.
3. The SEC did not act arbitrarily and capriciously with regard to estimating the cost of compliance of the proposed Rules because it adequately weighed comments to the proposed Rules and properly exercised its discretion in concluding which figures were most appropriate.
4. The statutory language of Section 1502 of the Dodd-Frank Act was not unambiguous and the SEC's rulemaking decisions were the products of reasoned decision making with respect to:
    a. Declining to adopt a de minimis exception;
    b. The "reasonable country of origin inquiry;"
    c. Extending the scope of the Rules beyond companies that manufacture products to do so cover companies that "contract to manufacture products;" and
    d. Adopting different phase-in periods for "smaller reporting companies."
5. The Rules survive a First Amendment challenge under an intermediate scrutiny standard of review.

Takeaways

1. The Rules will remain in effect, so companies should start their compliance process now or otherwise continue the compliance process in earnest.
2. Even if the plaintiffs appeal the court's decision, an appeal will likely not be concluded until

after the May 31, 2014 deadline for the filing of the first Form SD, so companies should start their compliance process now or otherwise continue the compliance process in earnest.
*[**Editor's Note**: The court's decision was appealed in 2013 and oral arguments were held in the U.S. Court of Appeals for the District of Columbia Circuit on Jan. 7, 2014. Because of the court's accelerated scheduling of oral arguments, a decision is expected before the May 31, 2014 deadline for filing the first Form SD.]*

3. Did we mention that companies should start their compliance process now?

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SEC social media guidance – tread carefully

April 5, 2013 | Erin Siegfried

As discussed in a post on April 2, 2013, the SEC issued a report on that date that contained guidance on the use of social media to publicly disclose material information under Regulation FD.

The report centered on the SEC investigation of Netflix and Netflix CEO, Reed Hastings, and whether Regulation FD was violated when Mr. Hastings disclosed on his Facebook page favorable news about the number of hours that Netflix streamed in a month. The SEC decided not to bring enforcement action against Netflix or Mr. Hastings, making recognition that there has been market uncertainty about the application of Regulation FD to social media.

Regulation FD provides that a public company, or anyone acting on its behalf, may not disclose material, nonpublic information to market professionals or securityholders when it is reasonably foreseeable that someone may trade on the basis of the information, unless such information is simultaneously disclosed to the public in a method reasonably designed to provide broad, non-exclusionary distribution of information to the public.

It is important to remember that whether disclosures comply with Regulation FD must be evaluated on a case-by-case basis. The SEC stated in the report that the disclosure of material nonpublic information on the personal social media site of a corporate officer, without advance notice to investors that the site may be used for this purpose, is unlikely to satisfy Regulation FD. The SEC explained that this is true regardless of the number of subscribers. The report focused on the fact that a company must notify the market about which forms of communication, including the social media channels, it intends to use for the dissemination of material nonpublic information.

The SEC expects issuers to rigorously examine the factors outlined in its 2008 website guidance that are taken into account when determining whether a particular channel is a recognized channel of distribution for communicating with investors. A company should ask itself several questions. Is the proposed channel of distribution one that is practical for investors to monitor? Do investors need "lead time" to register to use the channel of distribution? Is the company comfortable using only that channel of distribution for communications to investors? In any event, the company must be confident that the channel of distribution will provide for broad, non-exclusionary distribution of information to the public and it must provide adequate advance notice of the use of such channel to its investors. As best practices continue to evolve, companies should strongly consider continuing to use press releases, conference calls, and current reports on Form 8-K in addition to any social media channels to distribute material nonpublic information.

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